

**COORDINATED ISSUE  
ALL INDUSTRIES  
CUSTOMER BASED INTANGIBLES**

**ISSUE:**

To what extent can customer based intangible assets, acquired in conjunction with the acquisition of a going business, be amortized for federal tax purposes?

**BACKGROUND:**

Issues concerning customer based intangible assets arise in the context of a stock acquisition which is followed by a step-up in basis of the acquired corporation under former I.R.C. § 334(b)(2) or under section 338. These issues also arise in the context of an asset acquisition where a lump sum purchase price for the acquired business is allocated by the purchaser among the various component assets of the business. Stock and asset acquisitions in which intangibles issues arise typically involve the payment of a premium over the net fair market value of the tangible assets of the acquired corporation or business. It is this premium amount that the taxpayer will allocate to various intangibles for the purpose of claiming depreciation, rather than allocate the amount to nonamortizable goodwill and going concern value.

Customer based intangibles are those intangible assets which are closely associated with continuing the customer relationships developed by the acquired business. Examples of customer based intangibles include, but are not limited to, core deposits, customer or subscriber lists, subscriber base, patient lists, advertiser lists, and insurance expirations.

Core deposits are stable deposits which a bank or savings and loan association expects to retain for an extensive period of time, but which the depositors may terminate at will. The intangible is associated with the present value of the future cost savings from acquiring low cost core deposits to fund a bank's earning assets, instead of more expensive sources of investible funds. The core deposit intangible is also referred to as "deposit base."

A customer list is a compilation of the current, presumably recurring, customers of the acquired business. Similarly, a subscription list is a list of the current subscribers to the service or product offered by the acquired business, typically found in the media industry. Where the acquirer continues to operate the acquired business and effectively "steps into the shoes" of the prior owner, the customers and subscriber can be expected to continue their patronage in spite of the new ownership. Where the list

is acquired separately from a going concern (a "stand alone" list), it is used to identify potential customers, but the list alone generally carries with it no expectancy of continued patronage.

Similar to a subscriber list, the subscriber base intangible relates to the existing subscriber structure of a newspaper or magazine, which enables the acquired publication to attract advertising revenues.

Patient lists are similar to customer lists and subscriber lists, but arise in the acquisition of medical or dental practices.

An advertiser list is a listing of advertisers of a television station, radio station, or publication. These advertisers are, in effect, the "customers" of the acquired station or publication.

Insurance expirations are records which contain information of insurance policies covering fire, casualty, and other risks. The information contained in these records includes information on the insured, the dates of coverage of the policies, the type of policy sold, and the coverage of each policy. This intangible typically arises in the acquisition of an insurer or the business of an independent insurance agent. The value of insurance expirations lies in the information about the optimum time to approach an insured about renewals, and is generally measured by the expected commissions from policy renewals.

## **DISCUSSION:**

The purpose of this paper is to explain how to deal with a taxpayer's amortization claim for a customer based intangible asset relating to taxable periods prior to the enactment of I.R.C. § 197 (August 10, 1993). Historically, the Service took the position that customer based intangibles acquired in the purchase of a going concern were nonamortizable goodwill. However, recent developments in the case law make it clear that the amortization of any intangible asset (including customer based assets) is a question of fact, requiring both the Service and the taxpayer to develop the issue in terms of useful life and value.

I.R.C. § 167(a) is the controlling provision for the allowance for amortization of intangible assets acquired prior to the enactment date (or election-back date, where applicable) of section 197. Section 167 provides for a depreciation or amortization<sup>1</sup>

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<sup>1</sup> "Depreciation" and "amortization" are used interchangeably. Generally, "depreciation" refers to an allowance for the wear, tear, exhaustion or obsolescence of a tangible asset. "Amortization" refers to the periodic recovery of the cost of an

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deduction for the exhaustion of property used in a trade or business. Although section 167(a) does not specifically refer to intangible property, Treas. Reg. § 1.167(a)-3 recognizes that an intangible asset may be amortizable under certain circumstances. Treas. Reg. § 1.167(a)-3 permits amortization of an intangible asset if the asset is known from experience or other factors to be of use in the business or in the production of income for a limited period, the length of which can be estimated with reasonable accuracy. The regulation denies amortization for intangible assets which do not have limited useful lives, and states specifically that no depreciation is allowable for goodwill. Goodwill is nondepreciable as a rule of law because of the difficulties inherent in the computation of both its life and its value. Dodge Brothers v. United States, 118 F.2d 95 (4th Cir. 1941).

Until recently, "goodwill" had been variably defined as "the advantage that the proprietor of an existing business enjoys resulting from the probabilities that old customers will continue their patronage," Marsh & McLennan, Inc. v. Commissioner, 420 F.2d 667, 669-670 (3d Cir. 1969), quoting Thoms v. Commissioner, 50 T.C. 247, 256 (1968), or "the expectancy of continued patronage, for whatever reason." Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677, 681 (5th Cir. 1971), quoting Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962). Goodwill is acquired by a purchaser of a going concern where the transfer enables the purchaser to step into the shoes of the seller. Balthrope v. Commissioner, 356 F.2d 28, 32 n.1 (5th Cir. 1966).

Given this traditional definition of goodwill, the Service took the position that customer based intangibles were not amortizable as a matter of law because they represented the expectation of continued patronage from the acquired business's customers and, as such, were in the nature of goodwill or were inextricable from goodwill.

However, prior case law has been modified by the Supreme Court's holding in Newark Morning Ledger Co. v. United States, 507 U.S. \_\_\_, 113 S. Ct. 1670, 123 L.Ed.2d 288 (1993), rev'g 945 F.2d 555 (3d Cir. 1992), rev'g 736 F. Supp. 176 (D.N.J. 1990), and consequently the Service's position has changed. The Service will allow amortization for a customer based intangible where the taxpayer's appraisal meets the test of Newark Morning Ledger.

In Newark Morning Ledger, the Supreme Court allowed a taxpayer to amortize the present value of the net income projected to be earned from the subscribers of an acquired group of newspapers over the projected life of those subscribers. The Court unequivocally rejected the government's position with respect to customer based

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intangible asset. Both terms, however, describe the same concept, cost recovery, for which authority is found in I.R.C. § 167(a).

intangibles -- that the value of the customer relationships was inseparable from goodwill and was therefore nonamortizable as a matter of law. The Court held that

a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage.

113 S. Ct. at 1681 (emphasis supplied). The Court stated that defining goodwill as the expectancy of continued customer patronage is merely a "serviceable description of what we generally mean when we describe an intangible asset that has no useful life and no ascertainable value." 113 S. Ct. at 1676 n.9. "The value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage." 113 S. Ct. at 1675-1676. "The entire justification for refusing to permit the depreciation of goodwill evaporates, however, when the taxpayer demonstrates that the asset in question wastes over an ascertainable period of time." 113 S. Ct. at 1680. The majority opinion stated that its holding does not change the fact that goodwill is nondepreciable. 113 S. Ct. at 1680 n.13.

We are left with the question, then, what is goodwill? It appears that the Supreme Court subscribes to the view that whatever value remains of a going concern after all of its intangible assets have been ascribed values and useful lives is goodwill.

The Newark Morning Ledger opinion unquestionably applies to all customer based intangible assets. It is also clear from the majority opinion, however, that a taxpayer claiming amortization of a customer based intangible has a substantial burden to establish (1) that the taxpayer has accurately determined the duration of the claimed value of the asset, and (2) that the taxpayer has accurately determined its value.

The Supreme Court acknowledged that

Although we now hold that a taxpayer able to prove that a particular asset can be valued and that it has a limited useful life may depreciate its value over its useful life regardless of how much the asset appears to reflect the expectancy of continued patronage, we do not mean to imply that the taxpayer's burden is insignificant. On the contrary, that burden will often prove too great to bear.

113 S. Ct. at 1681. The Court cited several core deposits cases as examples where the Tax Court and appellate courts had concluded that certain core deposit intangibles could be amortized because those taxpayers had met their burden.

In Newark Morning Ledger, the government did not attempt to challenge the taxpayer's valuation methodology, nor did it challenge the useful life attributed to the "paid subscribers." Instead, the entirety of the government's case was its argument that amortization of the asset should be disallowed as a matter of law. Because the government had not developed the case factually, the government lost the case once the Supreme Court held that depreciability of an intangible asset is a question of fact. The lesson of Newark Morning Ledger is that the Service has to factually develop cases involving intangible assets, or else expect to lose these cases.

The Service has been relatively successful in those cases where it challenged taxpayers' valuation methods and useful life assertions. Where taxpayers have inappropriately valued and lived their intangible assets, the government has been relatively successful in challenging the taxpayers' claims and has generally prevailed with respect to the dollar amounts of the deficiencies. Thus, Newark Morning Ledger should not be taken as a signal that the Service is reluctant to litigate valuation and useful life issues if the factual development demonstrates that the taxpayer has not proven these elements.

### **The Taxpayer Should Identify the Claimed Asset**

The taxpayer must be able to specifically identify the asset which is claimed as a customer based intangible. For example, close scrutiny of a "customer based" intangible may reveal that it is actually a disguised workforce or market based asset. A claimed "advertiser revenues" or "advertiser relationships" asset may be a way of characterizing an advertising sales workforce in a manner that appears to be customer based, when the asset is actually an assembled workforce. Customer based intangibles are frequently mischaracterized as market based intangibles, as both seek to value revenues to be received from the customers, subscribers, or advertisers of the acquired business.

The importance of properly identifying the asset that the taxpayer is amortizing is due to a number of reasons. First, if an asset is mischaracterized, the Service could potentially develop the factual case (i.e., life and value) using different methodologies than if the asset is properly identified. Second, proper identification is necessary to ensure against "double counting" in valuation of the various intangibles claimed by the taxpayer. For example, if a taxpayer claims both a customer based and a market based asset, a portion of the revenues to be received from the acquired concern's present customer base may have been used to determine the present values of both assets. Proper identification of the assets allows the Service to closely scrutinize taxpayer's valuation methods to ensure that customer based revenues (i.e., future income derived from current customers) are not included in the revenue projections attributable to the market based intangible (which is represented by the present value of increased revenues from future customers).

### The Taxpayer Must Establish Useful Life and Value

The Service will not recognize customer based intangibles as amortizable under section 167 unless their useful lives and values have been substantiated. Amortization will not be permitted merely because, in the taxpayer's unsupported opinion, the intangible asset has a limited useful life. Treas. Reg. § 1.167(a)-3. Substantiation must be provided in the form of a properly supported and independent appraisal.

#### **Useful Life**

The fact that the customer based intangible has a limited useful life must be demonstrated by the taxpayer. Additionally, the duration of the useful life must be established. **The life which is relevant for amortization purposes is the actual, entire life of the composite whole, and not the average life of the units comprising the customer based asset.** Where statistical methods have been used to project the life of an intangible asset, the statistical projection should be compared with the taxpayer's actual post-acquisition experience. Lifting studies should, where possible, be reviewed by a statistician to identify lifting methodologies that are inconsistent with general statistical principles.

The taxpayer may not ignore the above-normal life of certain stable customer relationships, such as commercial accounts or long-term supplier relationships.

#### **Valuation**

With the exception of the core deposit cases, the government has focused more on whether the intangible asset is amortizable as a legal matter and less on whether the taxpayer's asserted value and life are accurate. Taxpayers now have an even greater incentive to allocate a large percentage of the purchase price to intangible assets, with the result that the Service must now focus its resources on challenging those valuation and useful life contentions.

In Newark Morning Ledger, the Supreme Court sanctioned the **income approach** for valuing customer-based intangibles. This approach is an appraisal methodology that measures the present value of future net income to be received from the customers existing on the date of acquisition, over the useful life of the asset. The income stream attributable to a customer based intangible:

- \* Must be determined based on the actual full term of the income stream, not its average life.
- \* Must be net.
- \* Must not include the return on any other asset (no double counting).

- \* Must be consistent with all other valuation assumptions made by the taxpayer.
- \* Should consider future income from only those customers of the acquired concern on the acquisition date; **the income stream should not reflect income from future or replacement customers.**
- \* Should include an after-tax discount rate that reflects the speculative nature of the asset (i.e., should reflect a higher discount rate for more speculative assets), and should use a higher discount rate for the specific asset as compared to the discount rate appropriate in valuing the business as a whole. If the rate used is not at least as high as the taxpayer's actual return on equity, further inquiry will be necessary.
- \* Should not be increased by an inflation factor.
- \* Should identify the costs (both direct and indirect) identifiable with the asset being valued.

Net after-tax cash flow may include a "tax shield," i.e., the present value of the tax savings attributable to the amortization deduction. See IT&S of Iowa, Inc. v. Commissioner, 97 T.C. 496 (1991), and Peoples Bancorporation v. Commissioner, T.C. Memo. 1992-285, where the court sanctioned the use of a tax shield. The after-tax cost savings may be computed in either of two ways. In Citizens & Southern and Colorado National Bankshares, for example, an effective tax rate of 20% was applied to cost savings unreduced by the amortization deductions. Alternatively, the statutory tax rate can be applied to the cost savings reduced by the amortization deductions. However, be alert to a flawed computation which applies an effective tax rate to cost savings reduced by the amortization deductions because the tax benefit of amortization is already included in the effective tax rate. IT&S of Iowa, Inc. v. Commissioner, *supra*, 97 T.C. at 532-533. See, e.g., Trustmark Corp. v. Commissioner, T.C. Memo. 1994-184.

If the taxpayer is using a **cost method**, this is acceptable. This method is based on the cost to replace or recreate the property or property of equivalent utility. Preferably, costs used should be the actual cost figures experienced by the taxpayer, as these are most indicative of the replacement cost. However, if these are unavailable, cost data of the industry is acceptable. Note that in applying the cost approach, accumulated obsolescence from all sources must be taken into account.

### **Amortization Method**

The **straight line method** is generally acceptable. If an accelerated method is used, it must be consistent with the rate that the customer based asset (not its present value) is projected to waste for valuation purposes.

### Treatment of Customer Based Intangibles Under Section 197

New Code section 197 was enacted on August 10, 1993, as part of the Omnibus Budget Reconciliation Act of 1993. Section 197 provides for the amortization of certain acquired intangible assets (called "section 197 assets") over a 15-year period beginning with the month of acquisition, using the straight line method. No other deduction for depreciation or amortization is allowed for amortizable section 197 assets. Except for a limited election for intangibles purchased after July 25, 1991, the legislation is not retroactive. The definition of "section 197 assets" includes goodwill, going concern value, customer lists or other information about current or prospective customers, core deposit base, or any other assets resulting from the future provision of goods or services pursuant to customer relationships.

The amortizability and useful lives of customer based intangibles will no longer be issues under section 197. However, the valuation issues will continue to present problems notwithstanding the enactment of this Code section. For years after 1992, taxpayers have an incentive in their reporting positions to understate the values of some section 197 assets, and overstate the values of tangible property with shorter recovery periods.

### **EXAMINATION POSITION:**

In view of the Supreme Court's holding in Newark Morning Ledger, it is no longer appropriate to view customer based intangibles as nonamortizable goodwill. A customer based intangible asset may be amortizable if, after factual development, the asset is shown to have a limited useful life and its value can be established with reasonable certainty. The taxpayer must be able to (1) identify the claimed asset, and demonstrate that it does not overlap with other putative intangibles claimed on the return; (2) demonstrate that the customer based intangible has a useful life of limited duration, and the useful life can be established with reasonable certainty; (3) demonstrate the asset's value with reasonable accuracy, with substantiation in the form of a proper appraisal; and (4) establish that its method of amortization is a reasonable one.

Because a case involving a customer based intangible requires factual development, examining agents are urged to consult a Service engineer or economist (or an outside expert in appropriate cases) for lifeing and valuation assistance. Although a taxpayer generally has the burden of proof with respect to the claimed useful life and valuation, the Service should always be able to specifically demonstrate why a taxpayer's appraisals or assertions are erroneous. General guidance on critiquing taxpayers'



appraisals may be found in the Intangibles Settlement Initiative Teleconference Handbook, Internal Revenue Service Document 9233 (2-94), Catalog Number 20566N.